

A foundation controlled by the creator's family is operated to enable the creator and his family to engage in financial activities which are beneficial to them, but detrimental to the foundation. This has resulted in the foundation's ownership of non-income-producing assets which prevent its carrying on a charitable program commensurate in scope with its financial resources. Held, the foundation is operated for a substantial non-exempt purpose and serves the private interests of the creator and his family, and therefore is not entitled to exemption from Federal income tax under section 501(c)(3) of the Internal Revenue Code of 1954.

The question has been raised whether a foundation organized and operated in the manner described below qualifies for exemption from Federal income tax under section 501(c)(3) of the Internal Revenue Code of 1954.

A foundation was created under a trust agreement between the donor and members of his family as trustees. The trust agreement sets forth exclusively charitable purposes and directs the trustees to pay over the entire net income to charity.

The creator and his family contributed a few shares of common stock in their family-owned corporation to the foundation shortly after its inception. At this point the corporation, whose capital structure consisted solely of common stock, was recapitalized. A first and a second class of preferred stock, each having voting rights equal to the common, was authorized. The first class was sold to members of the family; the second class was issued as a dividend on the common stock.

In the years following the recapitalization, the foundation acquired a substantial majority of the common stock. The larger portion of this stock was purchased from the creator and members of his family. In this manner the sellers realized appreciation in value of the corporation's assets, as reflected in its common stock, the gain being taxable at capital gains rates. The foundation also obtained additional common stock in the corporation through donations from the creator and his family. The donors claimed deductions as charitable contributions for the appreciated value of these gifts.

As a result of these transactions, the corporation's common stock became the foundation's principal asset. Concurrent with the sales and donations of the common stock to the foundation, the creator and his family increased their ownership of the corporation's preferred stock. This was accomplished by authorization and purchase of new issues of preferred, stock dividends on existing preferred, and various reorganizations between the corporation and other corporations controlled by the creator and his family.

Throughout this entire period the corporation consistently paid full dividends on its first preferred and partial dividends on its second preferred. No dividend was ever paid on the common stock. Since the corporation's common stock was the foundation's principal asset, the foundation's income was negligible in relation to the net asset value of its total holdings. As a result, the foundation was able to carry out only minimal charitable activities.

Despite the absence of dividends, the trustees of the foundation continued to purchase the corporation's common stock and failed to invest any sizable portion of the foundation's funds in other assets productive of income. Although the foundation was an important stockholder in the corporation, its trustees never exercised their fiduciary duty to the foundation by attempting to require the payment of dividends on the common stock or to prevent the issuance of additional preferred stock which diluted the underlying value of the common stock and inhibited the payment of dividends on it.

Section 501(c)(3) of the Code provides for the exemption from Federal income tax of organizations organized and operated exclusively for charitable purposes.

Section 1.501(c)(3)-1(c)(1) of the Income Tax Regulations provides that an organization will be regarded as 'operated exclusively' for one or more exempt purposes only if it engages primarily in activities which accomplish one or more of such exempt purposes specified in section 501(c)(3) of the Code.

Section 1.501(c)(3)-1(d)(1)(ii) of the regulations provides that an organization is not organized and operated exclusively for the purposes specified in section 501(c)(3) unless it serves a public rather than a private interest. To meet this requirement, an organization must establish that it is not organized or operated for the benefit of private interests such as the creator or his family, or persons controlled, directly or indirectly, by such private interests.

Members of the family of the creator of the foundation control the operation and investment policies of the foundation in their capacity as trustees. Through this control, the foundation has been operated to enable the creator and his family to engage in financial activities beneficial to them.

By a series of financial transactions involving the corporation, the creator and his family have succeeded in shifting the economic advantages and voting control in this company from the common stock held by the foundation to the preferred stock held by the creator and his family. The members of the family acting as trustees of the foundation have acquiesced in these transactions. As a result, the foundation owns non-income producing assets and is prevented from carrying on a charitable program commensurate in scope with its financial resources. Thus,

these activities have not only resulted in favorable tax consequences to the creator and his family, but their effect has also been detrimental to the charitable purposes of the foundation.

The use of the foundation as a vehicle for activities advantageous to its creator and his family and as a source of funds to finance such activities, the resulting investments by the foundation in assets which fail to produce income for a charitable program commensurate in scope with its financial resources, the continued failure of its trustees to protect the value of these investments, and their failure to make them income-producing, all establish that the foundation is operated for a non-exempt purpose, substantial in nature. That purpose is to serve the private financial interests of its creator and his family. The presence of such purpose is fatal to exempt status. See *Better Business Bureau of Washington, D.C., Inc. v. United States*, 326 U.S. 279 (1945) Ct. D. 1650, C.B. 1945, 375. Furthermore, the foundation fails to serve a public, rather than a private, interest and therefore is not operated exclusively for charitable purposes.

Accordingly, the foundation fails to qualify for exemption from Federal income tax under section 501(c)(3) of the Code.